October 31, 1991

COORDINATED ISSUE
PROPERTY & CASUALTY INSURANCE INDUSTRY
CAPTIVE INSURANCE AND/OR REINSURANCE COMPANIES

ISSUE:

Whether insurance premiums paid directly or indirectly to a captive insurance company are deductible by its parent (and related entities) under Section 162 of the Code where:

a) captive insures only related entities

b) captive insures third parties in addition to related entities

c) captive is owned by associations or groups of unrelated entities

TAXPAYER'S POSITION

The taxpayer maintains that insurance premiums paid to a captive insurance company in a, b and c above are deductible under section 162 of the Code, as the Internal Revenue Service ignored the principle of separate corporate entities.

FACTS AND DISCUSSION

The formation of captive insurance companies in tax haven countries as well as domestically has become widespread. Our latest information indicates that there are over eight hundred captive subsidiaries of U.S. corporations in Bermuda alone involving over $4 billion in annual premiums. It is estimated that the figure will rise to fifteen to twenty billion dollars in 1985.

Two states, Colorado and Tennessee have laws permitting the formation of domestic captive insurance companies. In addition, legislation is pending in New York State and Virginia which, if enacted, will approve domestic captives.

While numerous taxpayers maintain that the principal reasons for the formation of captives are to:

1. Provide insurance coverage at a lower cost

2. Provide unavailable coverage of high risks

3. Have access to reinsurance markets

It appears that the other salient reasons are:

1. To obtain an expense deduction under section 162 for payments that are actually for self-insurance

2. To transfer U.S. currency to tax haven countries where investment income earned is tax-free

3. Other reasons stated in IRM 45(11)9.1

Since the publication of Rev. Ruls. 77-316, 78-277 and 78-338 and the Service's success in the Carnation Co. case, numerous taxpayers have reoriented their operations of captives to include insuring of third party unrelated business. In both Rev. Ruling 77-316 and the Carnation case the captive insurance company insured only its parent and related entities. Some taxpayers believe that the issuance of third party insurance would then validate the deduction of insurance premiums as an expense under section 162 through risk-distribution and insulate them from Rev. Ruling 77-316 and Carnation.

Outside business has been obtained in various ways. i.e.:

a) Pooling arrangements - Exchanging one's own business for other companies' business

b) Reinsurance

c) Reciprocal deals

d) Direct underwriting

e) Associations

f) Syndicates

Additionally, unrelated corporations have formed group or association owned captives based upon Rev. Ruling 78-338 to circumvent the Carnation decision and Rev. Ruling 77-316.

LAW AND ARGUMENT

This law and argument section is divided into three sections, a, b and c, correlated to the subdivisions under issue.

a) Captive insures only related entities:

The basic ingredients of true insurance are risk-shifting and risk-distribution.

It appears to be well settled (pending appeal of the Carnation Company, 71 TC39, 12/26/78) that insurance premiums paid directly or indirectly to a captive insurance company by its related entities, which captive does not insure unrelated third parties, are nondeductible.

In Carnation, the taxpayer insured through and unrelated insurance company, with its wholly owned subsidiary, Three Flowers Assurance Company, Ltd. (a Bermuda Corp.). Carnation Company was the only insured of Three Flowers, its wholly owned subsidiary.

The Tax Court stipulated:

> "Held, to the extent that petitioner's risk was "reinsured" with its wholly owned Bermuda subsidiary, its risk of loss had not shifted, its agreement with the unrelated insurance company was not insurance, and its payment to the unrelated insurance company was not deductible as an ordinary and necessary business expense for insurance. Helvering v. LeGierse, 312 U.S. 531 (1941) followed.
>
> Held further, amounts received by petitioner's wholly owned Bermuda subsidiary pursuant to such "reinsurance" agreement are not includable in petitioner's income under Section 951, I.R.C. 1954.
>
> Held further, amounts received by petitioner's wholly owned Bermuda subsidiary pursuant to such "reinsurance" agreement are not characterized as income from sources without the United States for purposes of Section 904, I.R.C. 1954"

The additional capital agreed to be provided by Carnation insulated the insurer from risk and hence no risk-shifting.

As Carnation was the only insured of Three Flowers, the second ingredient of risk-distribution was missing and therefore, no true insurance.

For these reasons, it was concluded that the risk of loss remained in the economic family and there was no risk-shifting.

In Helvering v. LeGierse, 312 U.S. 531, it was determined that annuities and life insurance are opposite, one neutralizing the other.

Likewise, in Carnation:

> "The agreement to purchase additional shares of Three Flowers by Carnation bound Carnation to an investment risk that was directly tied to the loss payment fortunes of Three Flowers, which in turn were wholly contingent upon the property loss suffered by Carnation. The agreement by Three Flowers to "reinsure" Carnation's risks and the agreement by Carnation to capitalize Three Flowers up to $3,000,000 on demand counteracted each other. Taken together, these two agreements are void of insurance risk. As was stated by the Court in LeGierse, "in this combination the one neutralizes the risk customarily inherent in the other," 312 U.S. at 541.

In Peter Theodore, et al, Petitioner v. Commissioner of Internal Revenue, Respondent (Tax Court filed September 28, 1962) payments were made to a related insurance company that was owned approximately 80% by Theodore. These payments were disallowed in part under Section 482.

Again in Carnation, in reference to Theodore v. Commissioner, 38 TC 1011, the following was stated:

> "Had we recharacterized the agreements as being other than insurance agreements, none of the amounts paid to the insurance company by the taxicab company would have been deductible as ordinary and necessary business expanses."

It was clearly stated in Rev. Ruling 77-316 that insurance premiums paid to its wholly owned subsidiary were not deductible by its parent and related entities where the only insured were the parent and related entities.

Again it was stipulated that the arrangement lacked risk-shifting. The agreement to capitalize and the agreement to insure counteracted each other. The one who suffers the loss is the same one who sustains the economic loss.

The main taxpayers' argument is the failure by the Court and the Service to consider the separate entity theory.

While the Carnation case does not clearly discuss the question of separate entities, it was agreed that "some of the language in respondent's brief suggest that Carnation and Three Flowers are not separate entities."

In the LeGierse case there were separate entities, an unrelated insured and insurer.

It is respectfully submitted that the test of deductibility does not rely on the question of separate entities but whether there is an ordinary and necessary expense.

The question here is whether there is a genuine insurance expense for which we refer to the judgment of the U.S. Supreme Court in LeGierse. There appears to be no doubt that the definition of insurance must contain real risk-shifting and risk-distribution. Without either factor, we have no insurance expense.

The Carnation Court correctly observed that the Supreme Court's analysis did not depend on disregarding the two entities of insurer and insured.

In Steere Tank Lines, Inc., Plaintiff-Appellant v. United States of America, Defendant-Appellee the following was stated:

> "The taxpayer's payment of $200,000 into a contract premium account to satisfy financial responsibility requirements of federal and state regulatory agencies was not deductible as a business expense. There was no risk-shifting or risk-distribution (requisites of true insurance contracts) by the taxpayer who was required to pay any loss incurred by it."

b) Captive insures third parties in addition to related entities:

Some captive insurance company managers and tax representatives have expressed the opinion that third party insurance (to unrelated insured) would validate the insurance premium deductions by the parent or related entity.

It is our opinion that the underwriting of third party business, by itself, without the requisite risk-shifting and risk-distribution would not validate the corporate related deduction. This conclusion is supported by the U.S. Supreme Court decision in the LeGierse case in addition to the Carnation decision.

Where a captive allocates part of its capital contributed by its related entity to insure third party business, it is reasonable to assume that the related entity is still at risk and hence no risk-shifting.

The major question posed is whether writing insurance for unrelated companies would void the economic family concept in determining the deductibility of insurance payments by a taxpayer to a related entity.

In an article from Business Insurance, by Kathryn J. McIntyre (1-9-80) the following

quote by Carnation's attorney, J. Patrick Whaley, appeared:

> "Mr. Whaley cautioned against interpreting the IRS's reply to mean that outside business or multiple owners could remove a captive from the economic family theory, as many tax lawyers suggest."

Another article, Generating Outside Business for Captives, by Thomas A. Duffield and James V. Davis states the following: ---

> "Much is being said and written currently about captives taking on "outside" or "unrelated" business. It is not our intent to review the broad captive scene or list all the pros and cons of taking on unrelated business. That is a decision faced by each owner/operator of a captive insurance company. This article points out some things to be considered in that decision process.
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> The recent Tax Court decision which disallowed the deductibility of premiums paid by Carnation to its Bermuda-based insurance subsidiary should heighten interest of captives in acquiring unrelated business. A range of 20 to 30 percent of total premiums written eventually should come from outside business. While there is no case law in this area, premium writings of this magnitude should help achieve the risk-distribution which the I.R.S. argues is missing in the typical captive situation."

The following excerpt was taken from the Captive Insurance Company Reports dated August, 1978:

> "In the wake of Revenue Ruling 77-316, those concerned about the tax status of their captives have concentrated their efforts on trying to make their captive look, act, and "smell" like a real insurance company. One way captives are doing this is by taking on outside or so-called "third-party" business.
>
> <u>Conservative Tax Position</u>
>
> But a number of other lawyers are taking the position that premiums representing internal risks are non-deductible, regardless of any outside business. If this conservative position is eventually adopted by the IRS, then there would certainly be less pressure on captives to increase the amount of outside business written. It would also dash any hopes that captive parents may harbor concerning the tax deductibility of premiums paid to a captive.

No One Has the Answer

> In the final analysis, no one, including the "tax experts," really know what will eventually be deductible and what will not be deductible with regard to insurance premiums for corporate-related business. Advice today is probably only an educated guess and depends upon the aggressiveness and the motives of the expert offering the advice. Each captive owner's own tax position will influence the deductibility of "inside" premiums. Until more revenue rulings are issued, and tax court decisions are rendered, this will be the case for a long time to come."

The Journal of Commerce on March 31, 1980 contained an article, Future Syndicates May Open Door for Captives by Phil Zinkewicz wherein the following excerpts were taken:

> "Mr. Dudley, whose law firm was the moving force behind the formation of Aneco Reinsurance Co., a Bermuda-based reinsurance company which garnered investments even before it wrote a piece of business, said the New York exchange represents a prime opportunity for captive insurers to acquire new business.
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> "Captives are anxious to obtain some good, new third party business. The exchange represents a potential market for them and their tax situation makes participation in the exchange even more attractive." said Mr. Dudley.
>
> Initially intended to provide insurance coverages for their parent companies, captives have begun over the past few years writing more outside business, primarily to comply with the recent IRS ruling which applied to the Carnation case"

As there is no known case law specifically dealing with the question of captives writing outside business, some tax authorities are relying on Rev. Ruling 78-277 dealing with the question of whether premium payments made by a domestic parent to a foreign subsidiary are subject to the 4% excise tax.

Rev. Ruling 78-277 Specifically Stated

> "Insurance coverage provided by foreign subsidiary exclusively to U.S. parent. A contract under which a wholly owned foreign subsidiary, engaged exclusively in providing insurance coverage to the parent and its affiliates, receives a premium to insure the company and its domestic affiliates against certain high risk casualties is not a contract of insurance

subject to the tax imposed by Section 4371 of the Code.

The subsidiary is engaged exclusively in providing coverage to the parent company and affiliates and does not accept or solicit such coverage from parties outside the affiliated group.

One of the requisites of a true insurance contract is that there be present an element of risk-shifting or risk-distribution. See Guy T. Helvering v. Edythe LeGierse, 312 U.S. 531 (1941). See also Rev. Ruling 77-316, 1977-2 C.B. 53, which concludes, in part, that when there is no economic shift or distribution of the risk "insured," the contract is not one of insurance, and the amounts paid as premiums therefore are not deductible as ordinary and necessary business expenses for federal income tax purposes.

The foreign subsidiary in the instant case has not solicited or accepted insurance risks outside the affiliated group. Thus, in the event any member of the affiliated group should be reimbursed by the foreign subsidiary, there has been no economic change to the affiliated group because there has been no distribution of the burden of risk outside the affiliated group. Therefore, the element of risk-shifting and risk-distribution essential to an insurance contract is not present in the contract between the foreign subsidiary and the parent corporation."

Numerous tax managers have adopted the theory of Rev. Ruling 78-277 and concluded therefrom that outside business would automatically qualify a captive as a legitimate insurance company and therefore the premium payments by the parent and related entities would qualify as true insurance and be deductible under Section 162(a) of the Code.

c) Captive is owned by associations or groups of unrelated entities:

Since the Carnation decision and Rev. Ruling 77-316 numerous corporations with their wholly owned captives have rearranged their organizational structure to circumvent the "one on one" situation.

Rather than having one parent control the subsidiary captive, several unrelated corporations have formed one captive "insurance" corporation, with no one stockholder owning more than 50% of the voting stock and hence no direct control by one corporation.

Rev. Ruling 78-338 states, in part:

> "Business expense; premiums paid to foreign insurance company by shareholder.
>
> Amounts paid by a domestic petroleum corporation to a foreign insurance company that provides insurance against certain risks incurred in the petroleum business only to its 31 unrelated shareholders and their subsidiaries and affiliates, none of which owns a controlling interest and among which the economic risk of loss can be shifted and distributed, are premiums deductible under Section 162 of the Code, provided they are reasonable in amount for the coverage obtained and are based on sound actuarial principles. The tax imposed by Section 4371 applies to each such policy. Rev. Ruling 77-316 distinguished.
>
> The insurance company is not engaged in trade or business in the United States nor it is authorized to do business in the United States Pursuant to the bylaws of the insurance company, no shareholder's individual risk coverage may exceed 5 percent of the total risks insured by the company."

As specified in Rev. Ruling 78-338, the necessary ingredients of risk-shifting and risk-distribution are essential for a true insurance premium.

Care should be exercised that substance prevail over form. For example, some insurance contracts with group or association owned captives contain a retrospective rate credit, whereby the premiums of a member are adjusted to reimburse the captive for all or substantially all of its loss and thus no risk-shifting.

Another situation id spelled out in Rev. Ruling 60-275 whereby all the numbers of a captive located in the same valley, are insured for flood losses. Since the occurrence of a flood would create an economic loss for each member the effect is no real risk-distribution.

Rev. Ruling 60-275 States:

> "Since the eventual classification of the taxpayer with other member subscribers of the exchange will be limited to specific groups within the same flood district, each facing similar flood hazards, there is little likelihood that there could be a real sharing of the risks, because the occurrence of a major flood probably would affect all properties in a particular flood basin. Inasmuch as each subscriber to the instant exchange is substantially underinsured, any proceeds received by the taxpayer in the event of flood damage would, in effect, be a return of the taxpayer's own money."

Another self-insurance scheme is Rent-A-Captive. Rent-A-Captive arrangements have various plans whereby a U.S. domestic corporation pays premiums to an unrelated tax haven "insurance" corporation and takes a deduction for insurance premiums under Section 162(a). Subsequently, the premiums are returned or made available, with guaranteed interest, in the tax haven country. One Rent-A-Captive scheme involves the purchase of preferred stock of a Bermuda corp. with a guaranteed higher repurchase price.

CONCLUSION

In order to have a valid deduction for insurance premium expense under Section 162(a) of the Code, in all three situations cited above, there must be true shifting and risk-distribution. Insurance contracts which contain the two necessary requisites will qualify as a valid insurance agreement and premium payments therefore will normally be deductible under Section 162(a).

Where the validity of the insurance contract is approved, the tests of Sections 269 and 482 are appropriate. IRM 45(11)9 should be consulted in the overall guidelines and procedures.